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BACKGROUND MATERIAL FOR PUBLIC POLICY EDUCATION  
ON THE PROBLEM OF INFLATION \*

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This discussion attempts to cover briefly some of the background material that should be helpful to those who wish to do public policy education on the subject of inflation. It discusses:

- 1 - What is inflation?
- 2 - What causes it?
- 3 - What are the effects of inflation?
- 4 - When does inflation become dangerous?
- 5 - Possible alternative methods of controlling inflation.
- 6 - The present situation.
- 7 - The meaning of mobilization.

The discussion is largely laid within the framework of our present mobilization effort. No attempt is made to present background material for the broader problem of general economic stability because the author feels the problems now facing the economy in its attempt to carry out a limited mobilization are not exactly those of the general business cycle control and should be treated separately.

This material is primarily written for use by the extension specialist or county agricultural agent. There will never be perfect agreement as to the strength and desirability of using the various economic tools to control inflation. For this reason the subcommittee also has included some other suggested background reading to supplement this discussion.



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## I. What is inflation?

Inflation might be defined as an increase in the amount people are able and willing to spend for goods in relation to the amount of goods available. This means that prices will rise. The amount of price rise that can occur before it is called inflation is a matter of judgment. Rapid rises in prices, as we have experienced since June 1950, are definitely considered inflation.

These sharp price rises come from the interaction of supply and demand in the economy. On the supply side a curtailment of the civilian goods produced may limit supplies available for purchase. On the demand side it comes from people's willingness and ability to spend more for goods. Or it may come from inability to expand production as rapidly as spending in our "round-about" process of industrial production.

The important thing about inflation is that not all prices, incomes, and asset values rise together. The value of money or bonds as an asset drops while others, such as real estate, may rise. Thus, we can say that inflation results in a distortion of many price, income, and value relationships.

## II. What causes it?

It has already been mentioned that inflation is an increase in the money people spend in relation to the goods available. This situation may arise in several different ways.

- A. Shortage of goods - One of the great inflationary pressures in a defense economy comes from the decline in consumers' goods production. Since there is money being paid for total production, including military goods, it is all available to be spent on the scarce consumers' goods. The amount of inflationary pressure varies with the amount of goods going to military production.
- B. Investment expansion - One of the strong destabilizing factors in our economy is capital investment. An increase in the rate of capital investment is one of the strongest inflationary factors in our economy. The total gross private domestic investment was at an annual rate of \$44 billion in the first half of 1950. For the first half of 1951 this rate was \$61.8 billion. About \$10 billion of this increase was in non-farm producers plant and equipment.

This increase in the rate of investment puts a pressure on the raw materials used. It creates increased incomes without creating immediate production to offset the higher incomes. Thus, while its long-run effects may be deflationary it is inflationary in the short run.

- C. Inventory building - An inflationary pressure from the demand side may come from attempts of manufacturers, wholesalers, or retailers to increase their inventories. The \$16.3 billion increase in total manufacturing and trade inventories has been a strong contributor to our price rises from May 1950 to May 1951. This increase meant that manufacturers bid against each other for raw materials, wholesalers against each other for manufactured goods, etc. This type of inventory hoarding is likely to go on all through the economy including the consumer level when a shortage is anticipated at a later time.

D. Increase in the money or credit supply - Whenever there is an expected shortage of goods there is usually a scramble for them. This requires financing, usually through an increase in the money or credit supply. An increase in the money or credit supply may come from many sources.

1. Government deficit spending - When the government borrows money from the banks by selling them bonds a new deposit is created in the banks to the government's credit. When the government spends this money it enters the income stream and the banking system. It thus causes an upward pressure on prices and creates a wider base for the banking system to expand loans. The limit to this process is the gold position of the Federal Reserve Banks, if member banks can protect their individual reserve positions by selling part of the bonds to the Federal Reserve Banks. As yet we have had no increase in the money supply from government deficit financing since the Korean War began. In fact the government had a surplus of about \$3.5 billion for the fiscal year 1950-51.
2. Increase in bank loans - An increase in bank loans to private individuals has the same effect as an increase of bank loans to the government. As the new loans are spent they become deposits in other banks. This in turn gives the other banks reserves to make more loans as they only must keep a 14 to 24 percent reserve behind their loans depending upon the bank's classification. Thus, a \$1 million bank loan to government or business can mean as much as a \$6-7 million increase in the money supply if used to the fullest extent.
3. Increase in consumer credit - Any type of consumer credit that makes it possible for persons to buy more goods with a smaller down payment, or take longer to make the payments, acts to put an upward pressure on prices. All of these merely mean that people start to scramble for things in short supply or things they think will be scarce later.

This is a brief description of the way that an increase in the money supply or increase in credit supply can bring inflation. It should be emphasized, however, that these only make inflation possible and do not necessarily cause it. Banks had large excess reserves in the late 1930's but we had no inflation because few were willing to borrow. Even the government deficit spending at the same time had little effect. Thus, these factors only have inflationary effects if people and business are willing to spend or invest.

E. Spending from savings - Another factor that can increase the money available to buy goods, relative to the goods for sale, is a change in people's attitudes about savings. If they think goods may be scarce or higher priced in the future people may dip into their past savings to buy. If they think the employment outlook is brighter or feel more secure for other reasons they may reduce their rate of saving. In either case the effective demand for goods is increased. This change in savings may come from either individuals or corporations and has an inflationary effect in either case.

F. The cost-price spiral - Another cause of inflation is the cost-price spiral. A shortage of goods causes prices to rise. At the same time there is usually full employment or a shortage of labor. Under these conditions organized labor can use their power to push wages up and costs rise with them. The new effective demand thus created makes further price increases possible and likely to offset higher costs. The higher demand spreads to farm prices and increases living costs more and the spiral goes on again.

The possibility of a cost-price spiral is sometimes overlooked because people assume that organized labor cannot push wages up, and because they assume that competition will keep prices at a minimum. Neither assumption is true when the economy is near full employment or under the strain of war production. The cost-price spiral is possible under these conditions regardless of the availability of credit, government spending, or the money supply unless these items are so restrictive that unemployment reduces the wage push. It is most likely to occur when sharp rises in living costs occur as a result of shortages, but is possible whenever full employment is reached.

### III. What are the effects of inflation?

A. On production - The effects of inflation on production are mixed depending on the amount of inflation and its rapidity. A milder inflation will stimulate production, at least in some items. However, it also distorts it. If prices are rising rapidly, production may be directed toward consumer goods and services when we need more long-term investment in fixed capital assets. In a wild inflation production may be reduced as people take part in a scramble for real property.

Inflation may also affect worker's productivity and willingness to work. If consumption goods are scarce, the only incentive to work overtime comes from the right to save to buy more goods in the future. If inflation destroys the value of savings, this incentive is lost. People who have had this happen since the last war may be shy about getting caught again.

B. On consumption - Inflation has varied effects upon consumption as it does on production. Consumption by fixed income groups drops sharply during an inflation while that of groups that gain from inflation may rise.

C. On savings - The effect of inflation upon liquid savings is disastrous. A person who put \$100 into cash savings or insurance in 1939 as savings had only \$58.40 left in consumer purchasing power by 1949 and this had declined to \$53.80 by April 15, 1951. A decline of this kind is very serious for many reasons. It leads to a flight from savings, insurance, and government bonds into real property. The tragic effects upon the standard of living of retired persons, the income of endowed institutions, and others with liquid savings in fixed form is beyond economic calculation. If we are faced with this kind of reduction in the value of savings in the future who can blame persons for choosing to consume all of their income as it is earned. To do otherwise would mean throwing some

of the buying power away. This attitude, if it became widespread, could have serious effects upon the moral and economic structure of our Nation.

D. On investments - Inflation has varied effects upon different investments. A thousand dollars worth of farm real estate purchased in 1940 would now be worth about \$2,300 on the average. A thousand dollars invested in average common stocks in 1940 would now be worth about \$1,950. But, the same money invested in a government security would still only have the \$1,000 value. The same is true of most other types of bonds. Thus, inflation has a distorting effect on not only the earning power of persons, but also upon the value of the assets which they hold.

E. On groups in the economy -

1. Farm and other raw material prices - In general it may be said that farm and other raw material producer's prices rise faster and farther than other items during an inflation. Farm prices rose 28 percent from April 15, 1950, to April 15, 1951, while prices paid by farmers only rose 12 percent. During the same period other raw material prices rose 22 percent. Cotton prices rose 50 percent in that time, meat animals 37.2 percent, feed grains and hay 36.5 percent, but dairy products only 16.2 percent. The dairy farmer who must buy most or all of his feed has been squeezed by the rise in feed prices relative to milk prices. Thus, inflation may affect some classes of farmers as adversely as it does some other groups in the short run.

Farmers, or others that are in debt, gain from inflation as the price rises make the debt easier to pay. However, the inflation in land values that results from the price rise makes it just as difficult if not more so for a young man to start in farming.

2. Wages and the cost of living - There generally tends to be a lag in wages behind the cost of living in times of inflation. As labor becomes more organized and powerful they move to offset this and some sectors of organized labor may lead the inflationary rise. The cost of living has risen 9.6 percent from April 15, 1950, to April 15, 1951. During this time the hourly earnings of workers in all manufacturing industries has risen 9.8 percent while those in retail trade have only risen 6.9 percent. Because of longer hours the average weekly earnings of laborers in all manufacturing industries has risen 12.8 percent while the average weekly earnings in the retail trade is up only 5.8 percent due to shorter hours. White collar workers also fall behind during inflation as shown by the 8.7 percent increase in weekly earnings during the period for bank and trust company employees. Thus, the effects of inflation vary widely among different segments of labor depending upon their position and bargaining power.

Prospects of further inflation will lead labor unions to ask for more "cost of living" contracts to protect their real incomes. The widespread adoption of such devices will greatly shorten the lag in the cost-price spiral and make inflation even more rapid from this cause.

3. Fixed income groups - It is the fixed income groups that suffer most during an inflation. Retired persons living on savings, pensioners, white collar workers, teachers, and many others have incomes unrelated

to rapid changes in the price level. An inflation means that they must take sharp drops in real income and standard of living. If there is no decline in total goods for sale it means other groups in the economy are making gains at the relative expense of the fixed income groups. If part of the goods goes to war production, it means that the fixed income groups give up more than their proportionate share of those goods being diverted for defense.

F. The long-run effects - Many of the most important effects of a violent inflation are not felt immediately. Many of them may not be economic at all, but they are serious consequences a nation should consider when dealing with inflation.

1. Political - The fixed income groups in our society are a highly stable group. The effects of inflation on this group have already been discussed. If they are faced with a steady deterioration of their position they might not endure it politically for an indefinite period. They thus might support economic policies that are to the long-run detriment of the economy.

It has been claimed that the great inflation of the 1920's in Germany led this class of people to back Hitler in his rise to power or at least prevented their opposing him. The recent wild inflation in China may have given the communists much of the same support. While we don't face such a danger, it does help to show the riskiness of losing the political stability of the fixed income groups.

2. Social effects - Inflation also may bring undesirable effects of a social nature. Because of the distortion of incomes, young persons may draw away from entering fields which are important to our society. As a result of our inflation of the last 10 years we already have a shortage of adequately trained teachers. The proportion of young persons being trained for these and other "white collar" jobs will continue to decline if they are faced with the prospect of a declining real income.

3. Psychological - A point in this category is the economic attitudes which may develop because of strong inflations. People may come to regard saving as foolish and refuse to hold liquid assets or credit instruments which are necessary in a productive economy. When people come to expect steadily rising prices their attitude about holding money instead of goods changes, their attitude toward productivity and work may change and a whole new set of values may replace the normal ones. These in turn may lead to political and economic instability with undesirable results.

#### IV. When does inflation become dangerous?

Not all rising prices are bad. In fact a gently rising price level makes it much easier to absorb increasing productivity than an absolutely stable one which requires many internal adjustments. Thus, it is rapidity of price changes which makes inflation dangerous.

It is very unlikely that the United States could have an inflation of the explosive type that destroyed Germany after World War I and China after the last war. Our tremendous productive capacity and its ability to expand keeps the supply side strong, a factor that neither of the countries mentioned had at the time of their inflations. On the demand side we have a strong government with the ability to collect taxes. Our progressive income taxes, collected in advance furnish another brake to an explosive, self-feeding inflation.

This does not mean that inflation is not dangerous to our economy. We have taken the 10 percent price rise in living costs in the last year. If the public thought that this was to be a continuous process their reaction might be different. There would certainly be a movement from savings, government bonds, and other assets of this type to real assets. With our tremendous liquid assets in this country this would undoubtedly intensify the inflation. The final result could be a loss of confidence in the government and government credit which would set the stage for an explosive inflation of the worst type.

#### V. Possible alternatives

Nearly everyone agrees to some extent that inflation represents some danger to our economy. However, there is much less agreement on what to do about it. The suggested policy alternatives fall into four groups: (a) No controls, let the price system operate freely; (b) monetary and fiscal controls only; (c) monetary and fiscal controls buttressed by direct price, wage, and allocation controls; (d) direct price, wage, and allocation controls buttressed with monetary and fiscal policy.

Let us discuss these alternatives and some of the effects that each is likely to have.

##### A. No controls, let the price system operate freely

This policy is essentially that of allowing the price system to work freely in times of mobilization. People who advocate this point out that the price system is the basic mechanism which allocates resources and guides production. They say that disrupting it will hurt our productive ability. If prices start to rise because of inflation, production will increase, supply will increase in relation to demand, and prices will become stable or decline.

Our economy has a tremendous productive capacity and higher prices give it the incentive to expand. Total industrial production jumped from 190 (1935-39 = 100) in April 1950 to 223 in May 1951. Such an increase in supplies has helped keep the supply -demand relationships in line. When the increased production comes from increased productivity, the deflationary effects are even greater than if overtime work or new workers are required.

This situation is somewhat altered in the mobilization. When the government is buying some goods for military use, these goods are not available for civilian consumption. But, individuals receive wages, salaries, and profits when they help produce military goods as well as consumer goods and they will spend these incomes. Thus, government purchases of military goods will result in price rises even though the military goods are entirely achieved by increasing output or productivity. However, the more of the

military goods that come from increased output the less that will have to come from the real standard of living of the Nation as a whole.

This policy means that all resource use is allocated by price alone. The government will not have the power to allocate basic materials to defense producers, but will have to bid for the materials on the open market. Allocations are a form of control which prevent price from allocating resource use. When the government buys some of the output the difference between the total effective demand for non-defense goods and the previous value of the consumer's goods available to the public would then be called the "inflationary gap."

The use of no controls will lead to some inflation. The military budget would have to become progressively larger as prices rose. This may not be entirely undesirable. The military budget can be increased and the others held stable easier than non-defense expenditures can be trimmed with stable prices. In either case, it results in non-defense agencies being able to command less resources. Inflation without budget increases may be the easiest way to achieve this.

Any inflation that may result from no controls has some other possible advantages. It decreases the relative importance of the national debt in relation to money national income. It also puts some squeeze on fixed income groups which may force them into more productive jobs to maintain their levels of living. For short-run productivity this may be good although the long-run effects may be undesirable.

The policy of mobilization with no controls and of having some inflation as a result is one that might be offered. The other policies discussed are essentially attempts to remove or control the inflationary gap. Of course, all of the other policies would be aided by having increased productivity to relieve the supply side of the problem.

#### B. Monetary and fiscal controls

Monetary and fiscal control is an attempt to control the causes of inflation by removing the excess demand for goods. This policy would allow still prices to allocate resources throughout the economy. It would allow and encourage the increased production but attempt to drain off the increased demand it creates. To discuss monetary and fiscal controls they may be divided into several classes.

1. Monetary controls - In general, monetary controls are attempts to remove excess demand by controlling the money supply. Monetary controls have several advantages. They are impersonal in nature. They also have highly centralized control in an indirect manner. This means they can be effective without using great quantities of manpower for enforcement. Monetary controls operate under rather broad discretionary powers which make them more flexible to fit a particular situation and give them reversibility which is important.

(a) Direct monetary controls. One of the most common direct monetary controls is the limitation of the banking system's ability to make additional loans by affecting their reserve status.

(1) Change in reserve requirements - In our fractional reserve banking system each bank's loaning ability is limited by the amount of its reserves with the Federal Reserve Bank. If the monetary authorities wish to decrease the availability of commercial bank loans they raise the reserve requirements of the member banks which means member banks can make less loans on a given amount of reserves. The power to use this tool to limit bank loans has several weaknesses. Roughly half of the banks with about 15 percent of the banking assets are not members of the Federal Reserve System and thus can't be reached. Another limitation is the wide difference in the reserve positions of the various member banks. One may be loaned up so that an increase in reserve requirements would force it to call some loans to meet the new reserves, while another bank may have large excess reserves and their loaning ability wouldn't be touched by increasing reserve requirements.

The tightening of reserve requirements becomes useless if banks can merely sell government bonds to the Federal Reserve Bank to furnish the increased reserves or to expand loans. From the end of World War II until March 1951 such a practice was virtually encouraged as the Federal Reserve Banks stood ready to buy all such bonds offered for sale at a fixed price above par. Since March this has been discontinued and banks that sell bonds to increase reserves may have to take capital losses on them, which removes the profit from the operation. Thus, the use of reserve requirements is a much more potent weapon against inflation now than before. There is limitation set by law which limits strong use which might be necessary in a strong inflation.

(2) Direct bond reserves - Some persons have suggested that banks be required to hold a reserve of government bonds as well as cash behind their loans. This is another way to prevent expansion of the money supply through the liquidation of bonds to make inflationary loans. This would be a drastic measure which would reduce bank flexibility and probably would be strongly opposed by the banks. This method was used by some countries during the last war.

(3) Consumer credit regulations - One of the more effective brakes to inflationary spending is through regulation of consumer credit. The ability to require certain down payments and specify the length repayments can run has a great effect on the amount of spending people do for scarce goods. It has been most effective in housing, autos, and major household appliances.

(4) Margin controls for stock and commodity markets - The ability to control margins in stock and commodity markets can help control inflation by preventing speculation in the markets on money borrowed from banks. The Federal Reserve Board already has control of stock margins. Control of margins in the

commodity market has been refused in the present Congress and continues to be set by the individual exchanges.

(5) Forced savings - It has been suggested that forced savings would be a most effective inflation control. Under this plan each person would be forced to buy certain government bonds, to be determined by the amount of excess spending power available. These bonds would be cashable at some later date when more spending was needed. This is essentially another form of taxation which might be somewhat more palatable to the public. If effectively handled it could be a very strong inflation control.

(b) Indirect monetary controls - Indirect monetary controls are only a shade removed from the so-called direct monetary controls just discussed.

(1) Variation in interest rates - One of the oldest ideas in economics is that the amount of money people will borrow depends upon the interest rate and that the amount people will save also depends on the interest rate. In later years ideas have changed about the effectiveness of interest rates in influencing savings and borrowing. They are now felt to be much less effective than previously thought.

Federal monetary authorities have major control over interest rates because of the large Federal debt. It is generally agreed that raising interest rates does very little to deter borrowing in times of inflation. If it does have effects it may be on productive enterprises that should be encouraged and not upon those where curbs are needed. Higher interest rates also mean a bigger interest payment on the debt. However, higher interest rates can have important effects upon the availability of money to loan. And availability is the key to the prevention of loan expansion.

If the monetary authorities let the interest rate on government bonds rise, it means their capital value falls. If bonds are below par because of a rise in interest rates the banks will be putting a seal on a capital loss if they sell them. This limits the amount that banks will cash bonds to make new loans. A slightly higher rate will also encourage banks to use excess money to buy bonds rather than expand loans. It also encourages other institutions and individuals to do the same with their excess money. However, there is a delicate balance here. If interest rates on government bonds are allowed to rise far enough the capital value of them will fall considerably. Many of our banks have an extremely thin capital position and such a fall in value of a major asset could impair their solvency. The same effects would be felt by other institutions.

It is absolutely essential that faith in government credit be maintained. This means that the bond market will

be stabilized even though not supported at a fixed price. To do otherwise might cause a loss of confidence and result in a drastic inflation.

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Both direct and indirect monetary controls have their strongest role in limiting the availability of money in the banks or in the hands of the public. Changing the cost of money has become less important especially during inflation. Our problems have been greatly amplified by the large government debt held by the banks and the large liquid assets held by the public.

It should be mentioned that there are some limitation on the use of monetary controls to prevent inflation. If shortages of civilian goods and raw materials bring rapid price increases these will spread through the economy. Monetary controls cannot prevent these price rises. It would only be possible by making monetary controls so tight that unemployment would reduce effective demand by amounts approximately equal to the reduction in the supply of goods for sale. This, of course, would not be wise when all out production is needed.

Neither can monetary controls prevent a cost-price spiral unless used until unemployment takes the push out of the wage side. Unemployment is not feasible in a defense economy calling for all out production. Thus, monetary controls are limited to a prevention of inflation made possible from an increasing money supply.

2. Fiscal policy - Fiscal policy is in general an attempt to attack inflation by removing the excess demand through taxation. To do this it is necessary to remove the most spending power where it occurs. This is in the income groups of less than \$10,000 per year.

Taxation or changes in taxation require congressional action and it is usually impossible to get the taxes necessary to adequately prevent inflation as it is not politically popular to levy taxes on a broad base to reduce real income and standard of living. There is practically no tax that can prevent inflationary spending from savings. Any that have been proposed are administratively impossible. The general types of taxes and their effects are:

(a) Income tax - A properly levied income tax is a strong weapon to fight inflation. To be effective it must remove the excess purchasing power where it is - in the \$3,000 to \$7,500 class. Families with incomes over \$7,500 make up only 6.7 percent of our population and they are better savers.

To be effective the income tax must be excluded from living costs. If groups look at real income after taxation they will attempt to offset higher taxes with higher wages, prices, or profits.

(b) Manufacturer's excise tax - It has been proposed that a manufacturer's excise tax would be a good device to soak up excess spending

power. It is true that it would remove excess purchasing power but it would also have inflationary effects. It would be added to the consumers' price and cause a push for higher wages, raise agricultural parity prices, and add to the cost-price spiral in general. It could be applied in varying amounts to different items and help as a form of rationing for those in short supply.

- (c) Consumer sales tax - A consumer sales tax would have about the same anti-inflation values that an excise tax would. It has the added advantage of not being figured in prices to aid the cost-price push. A sales tax also has the same broad effects on low-income persons with no selectivity as to the ability to pay or equity.
- (d) Corporation excise profits tax - One of the most popular taxes is an excess profits tax. It does little to prevent inflation. First, corporations are usually savers in good times. Second, the excess profit tax encourages wasteful expenditures in the production of goods; and third, it removes most of the reluctance to inflationary wage boosts which add to the cost-price spiral. The corporation excess profits tax also, undoubtedly, affects prices. Corporations will try to maintain certain net profits after taxes, and a heavy excess profits tax will encourage them to raise prices to maintain profits. The tax has other inequities in terms of its effects on the growth of small businesses. However, it is politically popular and is an easy source of revenue.

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Monetary and fiscal policy have advantages and weaknesses to control inflation. A free price system encourages production which will make the inflation threat less. If used to the fullest extent, monetary and fiscal policy can remove nearly all of the excess demand created when goods are produced for defense.

It is not possible to prevent inflation due to a cost-price spiral or spending from savings by using monetary and fiscal policy. It would also be difficult to prevent sharp price rises on individual commodities using these indirect controls. Even so these tools are the most powerful to attack the basic causes of inflation.

C. Emphasis on monetary and fiscal policy buttressed with direct controls.

Advocates of this policy would use the monetary and fiscal controls to remove excess demand but would buttress these with direct controls. One of the first direct controls would be the right of the government to allocate scarce materials to producers of defense orders. If this is done then prices at the consumer level can no longer allocate resources and sharp rises due to shortages mean only inflation and can bring forth no increases in production.

There are two arguments for the use of at least some direct controls to back up monetary and fiscal policy in a period of mobilization. Most economists think it is impossible to carry out a mobilization with full employment and a seller's market without a strong cost-price spiral and its resulting inflation. Under these same conditions it is also difficult to prevent strong

groups from shifting their burden of the defense effort to others through wage increases, price increases, and higher profits.

The second argument for some direct controls is based completely on equity. If goods are to be scarce and more expensive should all of the supply go to the high-income groups? All of the people should make sacrifices, not just those who are forced to by higher taxes or higher prices. To many, price control and rationing treat people more fairly than a price-inflated market with goods in short supply. Whether this equity is desirable is strictly a matter of judgment and can't be debated on economic grounds, but it is a most important political consideration.

If direct controls are used to buttress a strong monetary and fiscal policy it is not likely that there would be a serious amount of excess demand to bring widespread rationing. However, the mere threat of controls may cause some persons to hoard goods and buy in advance of needs. On the other side direct controls may prevent some scarce buying that may do if they think prices will be higher.

Any direct controls also require large quantities of manpower, both within government and industry, to administer and keep the necessary records. This, of course, removes these people from more productive work in the defense effort. Controls may also hamper production efforts by failing to allow the necessary price incentives or by distorting the price structure between the raw material and its manufacture.

There is one other strong point against using direct controls during our present defense build-ups. Controls wear out. They become progressively more irritating and more difficult to administer as time passes. There is no doubt that we would need strong controls in case of all-out war. Many people say that we should save the live ammunition of direct controls for that possibility, rather than wear them out now.

#### D. Emphasis on direct controls buttressed with monetary and fiscal policy.

This policy would establish a strong set of price, wage, and material controls without too much attempt to control the excess demand in the economy. The result would be the type of suppressed inflation we had during World War II.

Direct controls without a strong use of monetary and fiscal policy only attack the symptoms of inflation and not the basic causes underlying it. A large suppressed demand would undoubtedly lead to black markets and rationing. Such a policy might not be feasible at all unless there was a strong patriotic urge, like war, to comply.

A large suppressed demand does encourage the fullest use of resources and fullest output from available resources and manpower since there is a ready market for all products. Strong monetary and fiscal controls may curtail the market for some products.

Suppressed inflation may lead to much malallocation of resources. Price incentives are required to get people to change jobs and to get increased output of needed goods. Strong direct controls may prevent the needed shifts.

The points regarding the equity of controls vs. the price system when goods are in short supply also apply when the emphasis is on direct controls. So do the points regarding control of the cost-price spiral. The objections to direct controls previously mentioned also apply here with added strength. More manpower is used and the controls would be much more difficult to live with. There has been no strong advocacy of the use of direct controls without strong fiscal and monetary policy to meet the present mobilization problem.

At least part of the explanation of the emphasis on direct controls during the last war may be explained by the condition of our economy when the war started. There is some justification for the creation of excess demand or for allowing inflation when there are unemployed factors of production to be attracted in the economy. When mobilization starts from at or near full employment this justification is removed.

## VI. The present situation

### A. What do we face

In general terms the situation facing the United States is an extremely difficult one. We are being called upon to rapidly build up our defenses until about mid-1953. Then our rearment is to level off or decline. At the same time we cannot afford to seriously dislocate our civilian economy for two reasons. One is that it would be politically impossible to rearm at the rate of the 1940's unless total war brought home the necessity to the people. Secondly, we may be entering a long period - perhaps generations - of cold or minor wars. We can't afford to weaken our economy now if we may be forced to fight an all-out war later. Thus, the problem is to provide adequate defense quickly without hurting our long-run economic growth.

Some idea of the strain on our economy can be shown as follows. About 6 percent of our gross national output went to defense before the Korean War. In the last quarter of 1950 this was only up to 8 percent. Now the pace of mobilization is increasing and in the second quarter of 1951 about 11 percent went to defense. By the end of 1951 this figure is expected to be up to about 15 percent with the top of 20 percent expected in mid-1952. Thus, the impact of the defense effort had not really begun to hit the economy during the past year's inflation.

One of our big inflationary pushes this last year has been in private domestic investment. Since Korea this has claimed 19 percent of our national output compared to 15 percent from 1946 to middle 1950. From the first half of 1950 to the first half of 1951 business expenditures for plant and equipment were up 44.3 percent, manufacturing inventories were up 29 percent, non-residential construction was up 55 percent. Part of this was due to a desire to get new plants and equipment before shortages came and prices rose, and part was due to the new defense orders. Much of it was financed from the 23 percent increase in bank loans.

Compared with the first half of 1950, personal income was up 14 percent in the first half of 1951. A continued rise is expected as we experience more price increases and the labor force increases in size.

One of the most spectacular factors in our economy has been the sharp increase in industrial production since the Korean War began. The Federal Reserve Index of industrial production rose 14 percent from May 1950 to May 1951. This combined with a plentiful agricultural production has furnished ample supplies of consumers goods to meet the increased demands. The result has been a noticeable lull in the inflationary pressures with declining prices in some areas. If we can continue to expand our production it may be possible to produce the necessary war materials without any major reduction in our real standard of living. Even so, there will be strong inflationary potentials as we increase our defense efforts.

B. What has been done regarding inflation?

1. Government action - The government action regarding inflation has varied greatly. After the passage of the Defense Production Act of 1950 in September 1950 several steps were taken to control credit by selective means. Installment buying curbs were put into effect which reduced the rise in installment credit to 1 percent in the fourth quarter of 1950 as compared to 10 percent in the third quarter. During the first half of 1951 there was a decline of 4.5 percent. Mortgage credit restrictions were tightened and effects became noticeable in the second quarter of 1951 when housing starts were 25 percent below the previous year.

On the general money supply side the Federal Reserve Board acted more slowly. Bank reserve requirements were not raised until early 1951 but they are now at their legal maximum except for an additional 2 percent requirement possible on demand deposits in New York and Chicago banks. Thus, this tool has been exhausted unless there is more further legislation.

Open market operations to control bank reserves were not effective as long as the Federal Reserve maintained the bond peg which allowed banks to convert bonds into loan reserves at will. After a long controversy between the Treasury and the Federal Reserve a new long-term non-marketable security with a higher interest rate was announced March 4, 1951. Shortly after this all bond pegs were dropped and other interest rates allowed to rise. Estimates as to the effects of this policy on inflation vary according to the observer. The Federal Reserve Board is still committed to stabilize the government bond market, especially during refunding operations, which may still allow banks to sell bonds and expand loans.

On the budget and tax side there has also been action. In late 1950 Congress enacted two tax increases which will result in about \$9-10 billion at our present level of incomes. Recently the House has passed an additional tax bill to bring in approximately \$7 billion more in taxes. This figure was still \$3 billion below the increase requested by the President. The fiscal year just ended found the government with a \$3.5 billion surplus. However, a sizable deficit is expected for the next year. An expected \$20 billion increase in personal income by 1952 will also greatly exceed the new tax proposals and thus add to inflation. However, this increased

income will also increase tax receipts by a substantial amount and may again aid in balancing the budget.

2. Non-government - On March 9, 1951, a voluntary credit control program was inaugurated by the Board of Governors of the Federal Reserve System covering all major financial institutions in the United States. Committees have been set up to guide lending institutions in their policies toward new loans. The effort is being made to bring voluntary restraints on non-defense lending. One example that is cited to show its effectiveness is the failure of the State of West Virginia to get any bids from investment banking syndicates on the \$67.5 million soldiers' bonus bonds. Even though plans had been made in advance for the financing it is claimed that a committee decision that the bonds were not in keeping with the program had a reversing effect. Apparently actions of this sort are being quietly taken throughout the country, but their effectiveness will be difficult to evaluate.

## VII. The meaning of mobilization

Mobilization and allocation of part of the Nation's production means but one thing. Whether it is done with no controls, monetary and fiscal controls, monetary and fiscal controls buttressed with direct controls, or primarily with direct controls does not change the facts. Mobilization means either an absolute decline in the real standard of living, or if production can be increased sufficiently, a failure to increase it by the amount productivity increases.

Inflation brings the decline about by bringing higher prices for the available consumer goods. The fixed income groups may maintain dollar expenditures, but their real consumption drops as prices rise. Thus, inflation essentially means a disproportionate share of defense production comes from the standard of living of fixed income groups. It is the inequity of this process that causes other alternatives to be offered.

All of the alternatives discussed are feasible policy alternatives which have been suggested by able and well-meaning individuals. Each would have somewhat different impacts on spreading the burden of defense. The long-run implications of each may be different but can only be guessed at. In the final analysis it will be political considerations, as expected in a democracy, that will be the determining factor.